CITIZENS FINANCE REVIEW COMMISSION

ANALYSIS OF PROPOSED

STATE OF ARIZONA ESTATE TAX

by

SUSAN KIMSEY SMITH, ESQ.
OLSEN-SMITH, LTD.
301 East Virginia Avenue
Suite 3300
Phoenix, Arizona 85004
sks@tax-law.com

PROPOSED STATE OF ARIZONA ESTATE TAX

by

SUSAN KIMSEY SMITH, ESQ.
OLSEN-SMITH, LTD.
301 East Virginia Avenue
Suite 3300
Phoenix, Arizona 85004
sks@tax-law.com

I. EXPLANATION:

The 2001 Tax Act Phase-Out of State Death Tax Credit. The Economic Growth and Tax Relief Reconciliation Act of 2001 ("The 2001 Tax Act") contains a phase out of the state death tax credit which has a significant impact on the revenues of many states. Beginning in 2002, the state death tax credit, which is allowed with respect to estate, inheritance, legacy, or succession taxes actually paid to any state or the District of Columbia in respect of any property included in the federal gross estate (up to a maximum amount, which varies with the value of the federal taxable estate) was reduced. The amount of the credit that would have been allowed by the application of the schedule and Internal Revenue Code of 1986, as amended ("IRC") IRC §2011(b) to the taxable estate was reduced to 75% of that amount in 2002, 50% of that amount in 2003, and 25% of that amount in 2004. The state death tax credit will disappear with respect to estates of decedents dying after December 31, 2004. Instead, after December 31, 2004, a deduction will be allowed from the value of the gross estate for the amount of any estate, inheritance, legacy, or succession taxes actually paid to any state or the District of Columbia, in respect of any property included in the federal gross estate. Unlike the state death tax credit, the deduction for state death taxes will not be subject to any maximum amount allowable, other than the actual amount of state death taxes paid. As a result, if a state calculated its estate taxes by the amount of the state credit allowed under federal law, all such estate taxes for that state will be eliminated if that state fails to change its estate tax laws.

A. Proposal. The proposal before the Commission is to "decouple" the amount of state estate taxes an estate owes to the State of Arizona from the amount of state estate tax allowed as a credit by the federal law (zero after 2004) by specifying that the state's estate tax will be equal to the amount of the federal credit for state death taxes as it stood **prior to** the passage of The 2001 Tax Act (i.e., $675,000.00). Thus, since Arizona currently has a "pick-up" tax and is therefore a "floating sponge tax state," the proposal would make Arizona into a state with an estate tax tied to the pre-2002 credit and Arizona would then become an "anchored sponge tax state."

B. Administration.

Since the federal unified credit is scheduled to increase over time until it excludes all estates valued at less than $3,500,000.00, many more estates will owe no federal estate tax as time goes on. However, a state with an anchored sponge tax determined by the 2001 federal tax laws (estates larger than $675,000.00) will still owe a state estate tax and will have to complete a federal estate tax return in order to determine the amount owed to the state, even though no federal tax is owed.

J. Elliott Hibbs, Director of the Arizona Department of Revenue, has noted that the proposal to decouple will impose additional burdens and responsibilities on the department with respect to estates that are required to file an Arizona estate tax return but are not required to file a federal return. He also noted four other specific administrative difficulties with the proposal:

1. "The department will not have a federal estate tax return from which to determine the gross estate. Therefore, the department will have to develop an Arizona return sufficient to provide this information."

2. "It will be difficult for the department to determine the existence of taxable estates when federal returns are not required."

3. "The department will have to issue estate tax closing letters based on Arizona audits." He noted that currently the department issues closing letters but only after a federal closing letter has been issued.

4. "The department does not currently have sufficient staff or expertise to conduct an estate tax audit in the absence of a federal audit (Revenue Agent's Report)."

Decoupling the Arizona estate tax from the federal estate tax filing threshold may cause the administration of the state estate tax to become even more complicated than envisioned by Mr. Hibbs if our state estate tax is based on federal law as it was in effect in 2001, rather than based on the law current at the time the estate tax is owed making a state estate tax audit based upon the 2001 federal estate tax laws almost an impossibility.

II. IMPACT ON EXISTING REVENUE SYSTEMS.

A. Direct Impact. Almost every state has been affected by the phase-out of the federal credits, although the impact of the changes to the federal estate tax on each state depends on the existing design of each state's estate tax. However, floating sponge tax states, like Arizona, are subject to the greatest impact. Enactment of the proposal and any resulting collection, net of increased administration costs, would run directly to the state as they do now. Enactment of the proposal should not effect the existing revenue system at either the county or local level.

B. **<u>Indirect Impact</u>**. It is possible that jobs and revenue from other sources (e.g., sales taxes, real property taxes, etc.) could be adversely affected by the proposal. Existing residents with gross estates in excess of $675,000.00 may change their domicile from Arizona to a state that is conforming to The 2001 Tax Act. In addition, potential wealthy residents may decide not to retire here or not move themselves and their businesses to our state. Due to the phase-out of the state death tax credit, the difference in states that have decoupled is as much as 4% in 2002, 8% in 2003 and 12% in 2004. Beginning in 2005, the top state estate tax in states that have decoupled will remain at 16%. Because the state estate tax will then be allowable as a deduction rather than a credit, this will reduce the net costs to 8.48% based on the top federal estate tax rate of 47% in 2005, 8.64% based on the top federal estate tax rate of 46% in 2006 and 8.8% based on the top federal estate tax rate of 45% in 2007 - 2009. This rate differential may be sufficient for taxpayers with large estates who live in states that have decoupled to change their domicile to states that have not decoupled.

In addition, it is worth noting that retention of Arizona's taxpayers with large estates (as well as the selection of Arizona as the future domicile of choice for wealthy taxpayers) may be impacted by the fact that California, Florida, Texas, Alaska and Nevada all have legal impediments to state estate taxes or decoupling from the phase-out of the state death tax credit. Some states have state constitutional prohibitions to the retention of a state estate tax and some states have statutory hurdles which require both voter approval as well as legislative action in order to decouple from the federal changes.

III. <u>COST</u>.

A. **<u>State Administrative Costs</u>**. As noted by the Arizona Department of Revenue, the proposal will impose additional burdens and responsibilities on the department requiring development of an Arizona estate tax form sufficient to supply the required information from which to determine the gross estate. Also, the department will have to increase staff and develop sufficient expertise to conduct an estate tax audit in absence of a federal audit and to begin to issue estate tax closing letters based on Arizona audits. As time marches on, if Arizona stays with the law as that law existed in 2001, the state may have to publish the federal law as that law existed in 2001 since the materials for that period will become increasingly scarce but will still be required for the state as well as for the Arizona estate planning attorneys and accountants.

Also, the enactment of any decouplization that would cause a retroactive tax effect may engender a constitutional challenge. Although constitutional cases challenging the retroactive application of federal taxes have largely been unsuccessful to date, it is possible, if not probable, that there would be a challenge to applying a new state estate tax to an estate or someone dying before enactment of the new state estate tax. Even if the taxpayer's representative was ultimately unsuccessful in such a challenge, the state would have to bear the cost of defending the retroactive application of its new state estate tax.

If no federal estate tax return is required, the state faces the problem of administering, monitoring and auditing "hypothetical federal elections." It may be possible to make those elections for state estate tax purposes that could have been made if a federal estate tax return had been required. Some of these would include QTIP elections (IRC §2056(b)(7)), alternate valuations (IRC §2032), special use valuations (IRC §2032(A)), conservation easements (IRC §2031(c)), and qualified family-owned business interest or "QFOBI" deductions (IRC §2057). The QFOBI deduction for federal estate tax purposes under IRC §2057(j) applies to decedents who die before 2004 but it may apply beyond 2003 for state estate tax purposes. Again, if the state denies any estate claiming one or more of the above, it would then face the burden of defending its denial if challenged.

Finally, the probate courts will undoubtedly experience a substantial increase in estates and trusts that seek a determination of "Will and/or trust constructions." In situations where it has become too late or impossible or even impractical to disclaim or where a partial QTIP election is not possible or desirable, many estates will attempt a state court construction of the Will or trust based on the "testator's intention" in an attempt to construe the marital deduction and the credit shelter formula in the decedent's estate planning documents to either reduce the taxable estate to the state exempt amount so as to eliminate both federal and state estate taxes at the first death or to increase the taxable estate so as to use any state death tax credit.

<u>Note</u>. A possible solution to some of these increased costs and administrative difficulties would be to implement a "partial decouplization." This could be accomplished by retaining an estate tax equal to the full amount of the credit in the pre-2001 law but at the same time incorporating the amount of the federal exemption increases that were part of that law. By adopting the federal exemption amount as the filing threshold for the state estate tax, only those estates that file a federal estate tax return would be required to file and pay state estate taxes. With a partial decouplization, no estate then would be required to complete a state estate tax form unless it was required to complete a federal form. However, the adoption of the current federal exemption schedule would reduce the amount of revenue that the state would retain from its estate tax unless the state also increased its estate tax rate in order to compensate since the top federal estate tax rate is scheduled to reduce to 45%. The reduced amount from 55% to 45%, a 10% difference, could be added back as a state estate tax with the net addition to the decedent's estate tax cost being only 5.5% since such amount would be deductible for federal estate tax purposes at a rate as high as 45%.

B. **<u>Individual and Business Compliance Costs</u>**. If Arizona adopts the proposal and becomes an anchored sponge tax state with a frozen federal exemption at $675,000.00 for purposes of the Arizona estate tax, individuals with estates in excess of the $675,000.00 will have to review and perhaps revise their existing estate plans.

Currently, Arizona's state death tax conforms to the state death tax credit. Many married Arizona residents currently have implemented estate plans that defer all federal and state estate taxes until the death of the survivor. This is accomplished by employing a typical martial deduction and credit shelter formula that results in a credit shelter amount of the maximum allowable exemption (i.e., $1,000,000.00 in 2002 and 2003) but no federal or state estate tax. The maximum available federal exemption is scheduled to increase to $1,500,000.00 in 2004 and 2005, $2,000,000.00 in 2006 through 2008 and $3,500,000.00 in 2009.

If Arizona adopts the proposal and allows only a $675,000.00 exempt amount, these existing plans will result in a state estate tax of $33,200.00 in 2002 and 2003, $64,400.00 in 2004 and 2005, $99,600.00 in 2006 through 2008 and $229,200.00 in 2009, assuming that the taxable estate is equal to the federal exempt amount. Thus, if a married couple wishes to defer both the federal and state estate taxes until the second death, they will have to incur legal and/or accounting fees in order to assess their situation and implement the appropriate solution.

The legal and accounting businesses will be subject to the costs of contacting clients who should be apprised of any changes that have been implemented, as well as the costs of developing the expertise to not only understand the impact of such changes, but also the cost of developing solutions to any estate planning modifications that should be considered and implemented. Thus, enactment of the proposal with its attendant complexity for married couples in Arizona with taxable estates equal to or in excess of, the federal exemption, portends an increase in the susceptibility of these professionals to malpractice actions as well as possible negligence claims.

IV. **POLICY CONSIDERATIONS**.

A. Equity. Both the federal and the state estate taxes are inherently progressive taxes. The Center on Budget and Policy Priorities ("Center") has stated that the "elimination or sharp reduction of state estate tax would benefit the wealthiest taxpayers in the state." The Center also notes that the federal estate tax in which the states share through the state estate tax credit is paid by the wealthiest two percent of the individuals who die each year and thus concludes that if a state loses its estate taxes as a result of the phase-out of the state death tax credit, it will lose "the most progressive element of their tax systems." Thus, the proposal to decouple the state estate tax credit in the federal law from the amount of tax an estate owes to the state would preserve the progressive element of this tax system.

The proposal, however, would not have horizontal equity. Only the wealthiest married individuals would have the means intentionally to pay tax at the first death, thereby reducing federal and state estate taxes overall at the death of the survivor. Married individuals of more modest wealth may be subject to higher estate taxes at the death of the survivor because they were unable to pay state estate taxes at the first death. See discussion under III(B) above.

The proposal would have vertical equity assuming that those married individuals with taxable estates equal to the federal exempt amount are able and do in fact analyze the impact of the proposal when it is enacted on their own individual situations and then implement the necessary revisions.

B. Economic Vitality. To avoid a significant loss of revenue, approximately 17 states and the District of Columbia have decoupled from the increase in the federal exempt amount or the phase-out of the state death tax credit. This has been accomplished by either enacting new legislation or by not adopting necessary conforming legislation. Some states allow the increase in the federal exempt amount but not the reduction in tax rates. Some states allow the increase in the federal exempt amount, but only up to a specified amount, such as $1,000,000.00. Some states allow the increase in the federal exempt amount that had been scheduled to take effect under the law prior to The 2001 Tax Act (i.e. $700,000.00 in 2002 and 2003, $850,000.00 in 2004, $950,000.00 in 2005 and $1,000,000.00 in 2006). Still, other states limit the exempt amount to $675,000. As the scheduled increases in the federal exempt amount and the scheduled reductions in the state death tax credit take effect, the impact on state estate tax revenues will increase. This makes it likely that additional states will decouple from the state death tax credit. See the attached Exhibit "A" prepared by the American College of Trust and Estate Counsel ("ACTEC") which lists pending legislation, if any, on a state by state basis as of June 3, 2003.

If Arizona decouples from the state death tax credit, it is doubtful that such a revenue structure would encourage "new investment", but whether or not it would be a source of discouragement is unknown. However, recent articles in professional journals relating to advising clients who are coping with the decoupling of state estate taxes after The 2001 Tax Act recommend that those individuals who live in the states that have decoupled should consider a change in domicile to a state that conforms with The 2001 Tax Act. This decouplization could have an effect on both attracting and retaining residents who have taxable estates equal to or in excess of the federal exempt amount. If Arizona decouples, it is unclear whether the economic impact will be consistent with the impact in other competitive states. The policy that the state revenue structure should keep Arizona competitive with other states will depend, of course, on what actions the other states take with respect to The 2001 Tax Act. As discussed in item 2(B) above, some states have state constitutional prohibitions to the retention of a state estate tax and some states have statutory hurdles which require both voter approval as well as legislative action in order to decouple from the federal changes. Such states may then come to tout their favorable estate tax rates as another lure to attract those individuals who will have (or anticipate having) taxable estates at death.

C. **Volatility**. The level of anticipated revenue which will be raised by the proposal is moderately volatile whether Arizona fully or partially decouples. The Center projects that the amount of revenue loss that Arizona can avoid over a five year period (2003 thru 2007) at $282,000,000.00 by fully decoupling and $236,000,000.00 by partially decoupling. The amount of revenue generated from decoupling, however, will depend on both the economy as well as the demographics of those Arizona residents who die with estates in excess of the exempt amount at the time of death.

The amount of revenue generated will also depend on the techniques which may be employed to reduce the amount of the state estate tax owed by those domiciliaries who employ knowledgeable professionals. For example, because the state death tax credit is based on the taxable estate, not including lifetime gifts, the effect of decoupling can be reduced or in some cases eliminated by making extensive lifetime gifts.

D. **Simplicity**. See discussion under item III.

E. **Economic Impact**. See discussion under item IV(B)

V. **OTHER RELEVANT FACTORS**.

A. **Reattachment**. The present estate tax law after the enactment of The 2001 Tax Act is unstable and imposes pressure on conforming states to make up the revenue lost by the phase-out of the state death tax credit. The revenue impact on the states is substantial both in absolute dollars and as a percentage of revenue. Although many states are considering decoupling from federal law, there are many different methods with varying effects that can be employed. See item 4(B) above. It is notable however, that some states which "decoupled" have now reattached to the federal system (e.g. Arkansas) or have voted to reattach (e.g. Virginia's legislature recently voted to reattach by a substantial majority but this legislation was vetoed by the Governor).

B. **QTIP Authorization**. Some states, like Tennessee and Massachusetts, have either proposed or have issued a directive from the state's Department of Revenue (e.g. Massachusetts Draft Department of Revenue Directive 03-X, January 16, 2003) allowing a separate QTIP election which can be made when applying the state's new estate tax based upon the federal state death tax credit prior to The 2001 Tax Act. If Arizona enacts the proposal anchored to the federal exemption amount of $675,000.00, the state also may consider legislating or "directing" allowance of a QTIP election on an amount that is equal to the difference between an amount that can pass to a credit shelter trust free of state estate taxes and the federal exemption amount or even regardless of whether a QTIP election is made for federal estate tax purposes. Note, however, that because a QTIP election affects a surviving spouse's estate, it may not be possible to make a QTIP election for state, but not for federal purposes, where the state estate tax in the surviving spouse's estate is based on the state death tax credit in effect at a given date rather than upon a separately calculated state taxable estate.

C. **Inheritance Tax**. Since relatively few states have an inheritance tax and Arizona has never had such a tax, Professor William P. LaPiana from New York Law School has provided the following analysis on a choice between an inheritance tax and an estate tax:

"I believe that there are three advantages an estate tax has over an inheritance tax.

First, the estate tax results in better horizontal equity than an inheritance tax. Horizontal equity in this context would require that taxable estates of the same size pay the same amount of tax. Because in an inheritance tax the rate of tax depends on the beneficiary, two taxable estates of the same size can pay very different amounts of tax depending on the identity of the beneficiaries. All current state inheritance taxes, as far as I know, exempt transfers to a surviving spouse and many exempt transfers to descendants and some even to spouses of descendants. Consider then two taxable estates of $2,000,000. In both cases the decedent is a widower. One, however, has living children, the other is childless. The former leaves his estate to his children, the other to his nieces and nephews. The latter estate is likely to pay a much higher rate of tax overall. Under an estate tax, absent exemptions or deductions that differentiate between lineal descendants and collateral relatives (and I know of no estate tax structured that way since the elimination of the so-called orphan's deduction) the tax paid by both estates is the same. As an aside, it is worth noting that because inheritance taxes often levy the highest rates on non-relatives, they are particularly hard on surviving unmarried partners. While under an estate tax no marital deduction is available, the tax is proportional to the size of the estate.

Second, an estate tax avoids certain administrative difficulties related to deciding what it is the beneficiaries have actually received. While valuation of the estate under the current federal tax is not without difficulties and controversy, the problems under an inheritance tax are even greater. Any trust that passes from the decedent to beneficiaries will create future interests. If those future interests are given to beneficiaries subject to tax, valuation difficulties exist. In the simplest case, say of a mandatory income only trust to a surviving spouse, remainder to descendants, where the spouse but not the descendants are exempt, so long as the descendants are all taxed at the same rate, it is easy enough to arrive at an actuarially computed present value of the remainder which can then be taxed. But what if the trust provides for invasion of principal? Or if the trust is not subject to the rule against perpetuities and is theoretically eternal? As I understand the workings of the current inheritance taxes, the value of such interests is negotiated between the state and the taxpayer, adding a level of administrative complexity that an estate tax escapes. In addition, the valuation problems faced by an estate tax are also faced under an inheritance tax. At least the estate tax is not regularly complicated by the valuation of future interests.

Finally, an estate tax modeled on the federal tax has another advantage. Any tax on the transmission of property at death that is limited to the probate estate would be a farce. The federal estate tax definition of the gross estate is well established, well understood, and known to practitioners. The various state inheritance taxes have different definitions of the reach of the tax, and while one could base an inheritance tax on the gross estate as defined by the federal estate tax, the problems outlined above would still exist."

VI. **CONCLUSION**:

A. **Suggestions**.

1. Do not "decouple" the State of Arizona estate tax from the federal estate tax for the reasons previously enumerated.

2. Stay "coupled."

B. Explanation. The top federal estate tax rate has been reduced from 60% for estates over $10,000,000.00 to an eventual top rate of 45% in 2009 pursuant to The 2001 Tax Act. Staying coupled with the federal law leaves room for the State to "pick up" the difference via the tax rates, since most taxpayers' estate plans are estimated based upon a 50% rate. In 2009, a state death tax of 8.9% of a decedent's taxable estate after federal exemptions which is deductible from the federal taxable estate would raise the top rate for both federal and state to a combined rate of 49.9% (45% + 4.9%), a little less than the previous top rate of 50%. The progressiveness of the prior rate structure could be maintained by adopting a state estate tax rate schedule which when "coupled" with the existing federal estate tax rate schedule would duplicate the pre-2001 Tax Act rates.

C. Advantages. The advantages of the above:

1. Progressiveness can be maintained;

2. The Federal Estate Tax Form 706 and federal auditing and administration would still be available to the Department of Revenue to determine compliance by decedents domiciled in Arizona;

3. The state tax rate schedule can be adjusted based upon the need for resources without having to <u>rewrite</u> the whole estate tax system each time additional resources are necessary for the State of Arizona;

D. Disadvantages. The disadvantages would include:

1. Having to consider the adoption of a separate estate tax system for Arizona if the federal government eliminates federal estate taxes. This scenario is unlikely since sixty (60) U.S. Senate votes are required for repeal of the federal estate tax and so far 60 votes have been impossible to attain.

2. Having to estimate the revenue to be received by the State of Arizona based upon an adopted rate schedule and an ever changing federal

estate tax law. The U.S. House of Representatives and the U.S. Senate have notoriously based tax changes over the last decade upon erroneous estimates of tax savings and costs and also upon erroneous assumptions. Hopefully, the State of Arizona can find a way to avoid duplicating such errors of estimation.